

Life after subprime.

by Lebowitz, Jeff

[Mortgage Banking](#) • Dec, 2007 • MORTECH Musings

We all are acutely aware of the terrible cost of the current crisis in the subprime market. In some ways, it is worse than we might have imagined.

According to *The Subprime Lending Crisis: The Economic Impact on Wealth, Property Values and Tax Revenues, and How We Got Here* (Joint Economic Committee [JEC], Washington, D.C., October 2007), here are some estimates of the potential household loss in equity when all of the accounting is done:

"For the period beginning in the first quarter of 2007 and extending through the final quarter of 2009, if housing prices continue to decline, we estimate that subprime foreclosures alone will total approximately 2 million.

* Approximately \$71 billion in housing wealth will be directly destroyed through the process of foreclosures.

* More than \$32 billion in housing wealth will be indirectly destroyed by the spillover effect of foreclosures, which reduce the value of neighboring properties.

* States and local governments will lose more than \$917 million in property tax revenue as a result of the destruction of housing wealth caused by subprime foreclosures."

What a disaster. The fallout from the unfolding national financial distress already has affected thousand of workers. According to Challenger, Gray & Christmas Inc., Chicago, financial service companies have announced 140,442 job cuts through October. With two months remaining in the calendar year, at press time, financial company layoffs already surpass the previous record of 116,647 annual job cuts set in 2001. In just August and September, financial job cuts totaled 73,436-46 percent more than the 50,327 financial cuts announced for all of 2006.

Looking for a fix

Look hard enough, though, and it is possible to find a brighter side to most crises. In front of the subprime meltdown, none other than Ben Bernanke, chairman and a member of the Board of Governors of the Federal Reserve System, located the silver lining in the current mortgage crisis.

Testifying before the Joint Economic Committee on Nov. 8, Bernanke spoke these very encouraging words: "Recent developments may well lead to a healthier financial system in the medium to long term. Increased investor scrutiny of

structured credit products is likely to lead ultimately to greater transparency in these products, and to better differentiation among assets of varying quality."

Surely the industry will be better off with tighter underwriting and appropriate risk pricing. To find relief for the individual borrower, regulatory agencies are pushing loan workouts as a way of cushioning the effects of impending default. The suggestion of pursuing massive workouts seems to carry a bleak and impermanent response to a systemic failure in the industry.

Even Bernanke's predecessor, Alan Greenspan, underscored the need to organize and codify loan mitigation and workout procedures. In an interview with CNN on Oct. 29, Greenspan argued that "the development of standardized approaches to workouts and the sharing of best practices can help increase the scale of the effort, even if, ultimately, workouts must be undertaken loan-by-loan."

I am mystified that such venerated economic and financial policy-makers would concern themselves with mundane operational solutions to a rip-roaring financial crisis. At a time when the very nature of mortgage banking may require redefinition, how far toward a comprehensive industry solution can improved procedures carry the industry?

Maybe the industry is more resilient than one would guess in the face of massive layoffs and widespread financial turmoil. How do lenders feel about their business prospects? As it turns out, lenders are not universally downtrodden. In fact, many are feeling pretty good about the near term.

In September and October, MORTECH LLC surveyed more than 300 lending organizations (MORTECH 2007). We found that more lenders saw business and profitability improving over the next 12 months than they did at this time last year (see Figure 1). And in confirmation of their optimism, fewer lenders in MORTECH 2007 thought they would end up with lower revenues and declining profits than they did in MORTECH 2006.

We learned a long time ago that the mortgage industry is composed of behavioral segments. We also figured out that when we see a change in lenders' perceptions of business conditions, we are seeing the first signs of changes in the business cycle.

Nervous market fears over the subprime crisis will resolve as lenders work through Sarbanes-Oxley and catch up on their balance-sheet analysis and financial reporting. Once a reasonably informed and shared opinion is had about the full extent of their asset write-downs, lenders will adapt and the business will continue--probably within a more conservative framework. Lenders, after all, are conservative people who work with the received wisdom of the time.

What of technology and the technology vendors?

Read the financial press. Little or nothing of note is said about suppliers of technology. Bernanke and Greenspan preach operational reform, but they give no hint about how they think change will occur or be managed to the industry's gain.

We think it important to know what the mortgage technology vendors are facing and how they are faring in these terrible times. To gather firsthand knowledge of the vendors' plight (if there is a plight), we formed an expert technology panel from the vendor community. The panel consisted of Bill Adamowski, co-founder and general partner, ISGN Technologies Ltd., Bensalem, Pennsylvania; Jonathan Corr, chief strategic officer, Ellie Mae Inc., Dublin, California; Brian Fitzpatrick, president, Lydian Technology Group, Jacksonville, Florida; Jeff Mouhalis, chief information officer and executive vice president, Fidelity Information Services' Mortgage Servicing Division, Jacksonville, Florida; Ray Petta, chief operating officer and executive vice president, Rapid Reporting, Fort Worth, Texas; and Linda Simmons, senior vice president, business development, Overture Technologies, Bethesda, Maryland.

We asked three things of the panel participants:

- * How have their customers coped in difficult times?
- * What should their customers be doing that they have not done?
- * What has happened to the vendors' businesses?

Despite the sudden departures of companies such as Irvine, California-based Portellus Inc. and Austin, Texas-based ARC Systems Inc., members of our panel were surprisingly optimistic. Most have suffered some loss of business. All felt that they knew how to do well in a down market.

What the panel said about lenders and their use of technology to cope might be summarized in the following way:

- * Almost all panel members saw their customers analyzing ways to introduce scale flexibility into their operations. They are looking at the substitution of capital for labor and offshore functions in lieu of domestic operations.
- * Lenders are investigating ways to make better decisions regarding the mix of product they originate. They are examining new product introduction against the recent histories of loan performance.
- * Lenders are allocating significant time and resources to improve product quality, verify data and ensure borrower and third-party qualification. The search is on for sets of best practices to improve compliance processes, fraud detection and collateral validation.
- * Finally, the push is on to uncover efficiencies and better methods to control costs. Profitability on loan origination has steadily decreased as lender costs have not aligned well with changes in production volumes.

Under the duress of falling margins and disappearing volume, lenders have taken on a mix of strategic and tactical changes. Our panelists each had some interesting observations on lender behavior.

In their own words

Bill Adamowski, ISGN Technologies Ltd.: "Change in this type of market is unavoidable. The processes that worked yesterday will not sustain the business today. Our customers are working with us to be creative and think outside the box for solutions that are right for their unique situations. Those who forge ahead by creating these types of partnerships will be ready when the market rebounds. Those who stick to the same old, same old, will be left behind and will no longer be competitive."

Jonathan Corr, Ellie Mae Inc.: "This is a time to think about changing business models, reinventing origination channels and investing in technology to differentiate from the competition. Our smart customers are doing just that. Lenders are also looking to reduce risk through their [third party origination] channels [wholesale and correspondent], and embracing the idea of using technology to increase visibility and predict risk of fraud, early payment default and pre-pay."

Brian Fitzpatrick, Lydian Technology Group: "Lenders will be under more pressure than ever to provide representations and warranties on their loans and loan data. At the same time, regulatory demands are becoming increasingly complex, and proposed enforcement powers granted by the legislature are becoming more potent. In this new environment, firms will have more exposure to reputation and litigation risk than ever, which makes services like Lydian's important in providing lenders proven expertise, technology and scale to allow lenders to inspect loan files more thoroughly at a reasonable price point. Every loan could be checked for fraud, poor data quality or compliance violations early and often in the origination process."

Jeff Mouhalis, Fidelity Information Services' Mortgage Servicing Division: "We are seeing a profound change in lenders' business preferences and industry structure. Clearly, the distress felt in the business has allowed our larger clients to strengthen and build out their business by consolidating abandoned assets. Hand-in-hand with the uncertainty in the market, we see lenders aligning with the stronger technology vendors. Fidelity has benefited by a 'flight to quality.' We have experienced massive growth in our default outsourcing business."

Ray Petta, Rapid Reporting: "Lenders that remain are addressing their risk exposure with renewed vigor to minimize losses and improve loan quality. We are seeing lenders focus on their underwriting guidelines, policies and procedures aligning more closely with Fannie [Mae] and Freddie [Mac]. Many lender programs have been eliminated, and they tend to be getting back to basic sound fundamental lending best practices. Lenders must do a much better job of verifying income, identity and collateral valuations if they wish to avoid the current industry problems."

Linda Simmons, Overture Technologies: "Some clients and prospects are full-speed-ahead with efforts to move forward with more robust solutions and support for the future state. These entities have suffered less from subprime issues and are able to leverage the momentum in the conforming and FHA [Federal Housing Administration] markets. Other clients and prospects are struggling with the issues highlighted in the press, and are slowing dramatically. Customers need to focus on the characteristics of good decisions and capture them in an automated decisioning

solution. This focus may result in the creation of a new function called re-decisioning--if I knew then what I know now, what would I have done differently?--as a means for moving forward."

Jeff Lebowitz is founder and principal of MORTECH LLC, Guilford, Connecticut. He can be reached at jeff@mortech-llc.com. Figure 1 Expected Lender Performance for the Next 12 Months Lenders look more optimistic for 2008: in the press, the situation is grave

% of Respondents

MORTECH 2006 MORTECH 2007 Expecting Profitable Growth 23% 29% Expecting Decline 20% 15% SOURCE: MORTECH LLC Note: Table made from bar graph.